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Contact: Sam Eskenazi (202) 874-5770
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OCC Issues Leveraged Lending Advisory

WASHINGTON -- The Office of the Comptroller of the Currency today warned banks about the elevated risks associated with leveraged lending activities, and established risk management expectations for national banks engaging in leveraged lending.

"When used judiciously, leverage serves to support business growth and increase returns to investors," said Comptroller of the Currency John D. Hawke, Jr. "However, when the use of increased debt does not generate sufficient cash flows or asset values, both primary and secondary repayment sources may be quickly and seriously impaired. As a result of this increased risk, leveraged lending requires more intense account and portfolio management than many other types of lending."

Deputy Comptroller for Credit Risk David D. Gibbons said his "concern lies not only with the growth of leveraged lending in the past several years, but also with the easing of underwriting standards and credit discipline that has accompanied the growth of leveraged lending activities. The combination of high leverage and relaxed underwriting significantly increases the risks associated with this form of lending."

The advisory is broadly directed at the risks in credit arrangements that exhibit one or more of the following characteristics:

The borrower's debt to equity is significantly above the norm for its industry.

The borrower is in an industry, such as hedge funds, that typically uses significant financial leverage.

Loans or portions of loan arrangements are structured with:

- minimal principal amortization or deferred repayment plans;
- enterprise value -- the estimated value of a business -- or its equivalent being used to augment or otherwise mitigate deficient equity and collateral values;
- repayment primarily dependent on refinancing or recapitalization; or
- primary and secondary repayment sources closely linked to achieving aggressive growth projections.

Such lending arrangements are commonly used to finance mergers and acquisitions, business recapitalizations, equity buyouts, and expansion of a business or business lines.

High debt levels increase the risk of default. Leveraged borrowers typically have high debt levels relative to equity, income, or cash flow. As a result, they often have less ability to withstand adverse economic conditions or budget shortfalls to take advantage of new business opportunities, or to make necessary capital expenditures.

The advisory also discusses features found in today's leveraged lending activities that heighten risk and warrant more intensive risk analysis, monitoring, and management. These include:

- Debt structures and collateral;
- Repayment terms;
- Reliance on enterprise value;
- Reliance on refinancing or recapitalization;
- Interdependent repayment sources;
- Reliance on equity sponsors and agent banks;
- The inability to syndicate or sell down a transaction; and
- Hedge funds.

The OCC encourages national bank participation in all lending activities that are creditworthy and consistent with sound banking principles, and such activities can include leveraged lending. However, managing the risks inherent in leveraged lending is a complex task. In addition to exercising the risk selection, underwriting, credit administration, and portfolio management discipline required to safely manage the risks associated with lending in general, management must exercise additional diligence to properly identify, measure, manage and control the higher and unique risks associated with leveraged lending.

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The OCC charters, regulates and examines approximately 2,600 national banks and 66 federal branches and agencies of foreign banks in the United States, accounting for 58 percent of the nation's banking assets. Its mission is to ensure a safe, sound and competitive national banking system that supports the citizens, communities and economy of the United States.